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October 2, 2003

### Via Electronic Filing

Marlene H. Dortch Secretary Federal Communications Commission 445 12<sup>th</sup> Street, S.W. Washington, DC 20554

Re: Ex parte, Appropriate Framework for Broadband Access to the Internet over Wireline Facilities; Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services

CC Docket Nos. 02-33 and 01-337

#### Dear Ms. Dortch:

AT&T Corp. ("AT&T") submits this *ex parte* presentation in the above entitled proceedings to respond to a recent submission by BellSouth<sup>1</sup> that again requests the full and preemptive deregulation of broadband services for all purposes except those related to the Commission's cost allocation rules. As AT&T indicates in the attached ex parte presentation, the cost allocation rules, in conjunction with other regulatory safeguards, remain critical to help prevent carriers with market power from acting on their incentives to misallocate costs.

Consistent with section 1.1206 of the Commission's rules, I am filing one electronic copy of this notice and request that you place it in the record of the above entitled proceedings.

Sincerely,

cc: W. Maher

C. Mattey

M. Carey

B. Olson

D. Cooper

T. Natoli

<sup>&</sup>lt;sup>1</sup> Letter of Stephen L. Earnest, BellSouth, to Marlene H. Dortch, FCC, CC Docket No. 02-33, (filed Aug. 26, 2003).

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October 2, 2003

### **By Electronic Mail**

Marlene H. Dortch Secretary Federal Communications Commission 445 Twelfth Street, S.W. Washington, D.C. 20554

Re.

Framework for Broadband Access to the Internet Over Wireline Facilities,

CC Docket No. 02-33

#### Dear Ms. Dortch:

I am writing on behalf of AT&T Corp. ("AT&T") in response to an *ex parte* letter recently filed by BellSouth regarding the treatment of broadband services under the FCC's cost allocation rules. BellSouth again requests that the Commission fully and preemptively deregulate broadband services for all purposes save one: with respect to the Commission's cost allocation rules (47 C.F.R. §§ 64.901-64.903; *id.* §§ 32.27 *et seq.*), broadband services would be paradoxically considered "regulated." Not surprisingly, there is no legal argument that supports this approach, and BellSouth therefore asks the Commission to "engineer" BellSouth's "desired goal" solely based on "policy." Letter at 1. Even if the Commission had authority to do that – and it does not – BellSouth is simply wrong that it would be wise policy. The cost allocation rules, in conjunction with other regulatory safeguards, remain critical to help prevent carriers with market power from acting on their incentives to misallocate costs. Broadband costs, in particular, would present massive opportunities for cost misallocation if exempted from the Commission's rules, as BellSouth essentially admits.

1. BellSouth does not dispute that if broadband services were deregulated in the manner requested by BellSouth, current Commission rules would require BellSouth to separate the costs of such newly deregulated services from the costs of their regulated operations. See Letter at 3 (requesting additional "relief" from rules). BellSouth claims, however, that these

<sup>&</sup>lt;sup>1</sup> Letter of Stephen L. Earnest, BellSouth, to Marlene H. Dortch, FCC, CC Docket No. 02-33, (filed Aug. 26, 2003) ("Letter").

longstanding rules should be eliminated for "broadband" because price cap regulation "eliminates the need to allocate joint and common costs." *Id.* at 3. This claim is baseless, and has been flatly rejected by the Commission.

When the Commission adopted price caps in 1990 for large incumbent LECs, it expressly decided to retain its cost allocation rules.<sup>2</sup> That is because price cap regulation and cost misallocation rules are complementary regulatory tools that are designed to attack what the Commission has elsewhere described as the "fundamental postulate" of all "modern U.S. telecommunications law" – that incumbent LECs with market power have "both the incentive and ability to discriminate against competitors in . . . retail markets." Price caps are designed to reduce the LECs' *incentive* to misallocate costs – but because (as described below) price caps alone could never entirely eliminate these incentives, additional rules and safeguards, such as the cost allocation rules, are necessary to detect and deter the incumbent LECs' *ability* to misallocate costs to the detriment of captive ratepayers and competitors. That is why the Commission has consistently affirmed that its cost allocation rules remain an "important component" of its accounting safeguards, <sup>4</sup> notwithstanding the existence of price caps. Thus, the Commission has already rejected BellSouth's argument and determined that "interstate price cap regulation does *not* eliminate the need for cost allocation rules." *Accounting Safeguards Order* ¶¶ 58, 271 (emphasis added).

BellSouth suggests that these Commission pronouncements rejecting its principal argument are no longer valid because the "marketplace and regulatory paradigms have shifted." Letter at 5. But BellSouth's off-handed claim that "[c]ompetition has increased" (id.) falls far short of the "changes in competitive conditions" to which the Commission referred in 1996 when it stated that it "may" re-examine the need for its cost allocation rules. Accounting Safeguards

<sup>2</sup> In the Matter of Policy and Rules Concerning Rates For Dominant Carriers, 5 FCC Rcd. 6786, ¶¶ 396-97 (1990).

<sup>&</sup>lt;sup>3</sup> Applications Of Ameritech Corp. And SBC Communications Inc., For Consent To Transfer Control, 14 FCC Rcd. 14712, ¶¶ 12, 190 (1999) ("SBC-Ameritech Merger Order"); In the Matter of Implementation of Section 254(k), 12 FCC Rcd. 6415, ¶¶ 2, 6 (1997) ("Section 254(k) Order"); see also United States v. Western Elec. Co., 969 F.2d 1231, 1238 (D.C. Cir. 1992) ("a corporation that enjoyed a monopoly on local calls would ineluctably leverage that bottleneck control in the interexchange (long distance) market"); United States v. American Tel. & Tel. Co., 552 F. Supp. 131, 188 (D.D.C. 1982) ("there are many ways in which the company controlling the local exchange monopoly could discriminate against competitors in the interexchange market").

<sup>&</sup>lt;sup>4</sup> In the Matter of Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Services, 11 FCC Rcd. 18564, ¶ 39 (1996); Report and Order, Accounting Safeguards Under the Telecommunications Act of 1996, 11 FCC Rcd. 17539, ¶ 58 (1996) ("Accounting Safeguards Order").

Order ¶271. Only sustained and fully robust local competition, including deployment of ubiquitous alternatives to the incumbents' bottleneck facilities, could sufficiently eliminate the incumbent LECs' market power and their incentives to misallocate costs. BellSouth, of course, does not even suggest that this level of competition exists in any market, and the indisputable fact is that it and other incumbents remain dominant in the provision of local services. BellSouth would nonetheless have the Commission create an exemption to its longstanding cost allocation rules, which it previously found were "necessary to brake the [incumbent] carriers' potential for abuse" and to prevent incumbents from leveraging their dominance. See Southwestern Bell Corp. v. FCC, 896 F.2d 1378, 1381 (D.C. Cir. 1990) (affirming the Commission's joint cost rules as a reasonable "response to systematic incentives to shift costs," particularly in light of "regulatory history," which "expose[d] the fallacy" of the LECs' arguments that more "finely tailored means of regulatory oversight would sufficiently protect against possible cost misallocation").

Further, price cap regulation has not eliminated the incumbents' incentives to misallocate costs to their monopoly services. Indeed, the most that BellSouth can claim is that regulation has eliminated only the "direct link[s]" between costs and rates (Letter at 4 (emphasis added)) - but that leaves numerous indirect links, and therefore plenty of reasons why incumbents continue to have the incentive to inflate the costs of their regulated services and understate the costs of services - like broadband - that face some measure of competition. This is because, in practice, price cap regulation is effectively only a modified form of rate-of-return regulation. The "index" used to adjust rates is always subject to change by the regulator, and the typical basis for altering the index is that a company's costs have increased at a greater rate than the index. See Kenneth Train, Optimal Regulation 327 (1991) (under price cap regulation, a firm will have incentive to "waste so as to convince the regulator to allow a higher cap"). For that reason, as the Supreme Court held in 2002, "price caps do not eliminate gamesmanship," primarily because price caps are "simply . . . a rate-based offset" that, like rate-of-return regulation, still provides "monopolies too great an advantage." Verizon Communications Inc. v. FCC, 535 U.S. 467, 487-88 (2002). And this is no theoretical concern: because the CALLS plan is due to expire soon, the incumbents have powerful incentives to shift costs in order to support higher exchange access price caps going forward.

<sup>&</sup>lt;sup>5</sup> Because robust competition and the elimination of control of bottleneck facilities are the ultimate protections against cost misallocation, AT&T's statements in 1993, quoted in BellSouth's Letter (at 5), are simply inapplicable to BellSouth and other incumbent LECs. AT&T had divested its bottleneck facilities nine years before and faced full competition from MCI, Sprint and others. That is why AT&T could contend that the "basic assumption" underlying price cap regulation was "entirely inapplicable to AT&T." However, that basic assumption is fully applicable to BellSouth and other incumbents, which maintain firm control of bottleneck facilities.

Further, as AT&T has previously pointed out, the incumbent LECs are not even subject to "perfect" price cap regulation and therefore retain strong incentives to pad costs of regulated services. First, as BellSouth admits, some states "continue rate of return regulation for intrastate services." Letter at 6, and in those areas there would be a "direct" link between the incumbents' costs and prices - and thus the tremendous incentive for incumbents to inflate the rate base. Further, even in states that have adopted price caps for intrastate services, many such state price cap systems have retained sharing or other periodic earnings reviews, which, as BellSouth concedes, could likewise "create a direct link from the costs incurred to the rate increases." Letter at 5. Notably, the Commission relied expressly on these two facts in 1996 when it found that the interstate "price cap regulation does not eliminate the need for cost allocation rules" and that such rules "remain important to our efforts to ensure that the rates for regulated services are just, reasonable, and nondiscriminatory." See Accounting Safeguards Order ¶ 271 ("Moreover, because these incumbent local exchange carriers' intrastate services may be subject to cost-of-service regulation or to a form of price cap regulation that involves potential sharing obligations or periodic earnings reviews, the incumbent local exchange carriers may still have an incentive to assign a disproportionate share of costs to regulated accounts").

Second, even though the interstate price cap system no longer includes a sharing obligation, the incumbent LECs would nonetheless obtain significant benefits by virtue of the fact that they could, in the absence of cost misallocation rules and other safeguards, misallocate costs to their regulated services. For example, by manipulating its affiliates' costs to artificially low levels, an incumbent can effect price squeezes on its rivals even as it appears to comply with imputation requirements. Further, if BellSouth and other incumbent LECs could shift a disproportionate share of the massive joint and common costs away from broadband services and to regulated local services, they could be able to boost substantially prices for essential services, such as unbundled network elements, that they provide to downstream rivals. For these reasons, even if "perfect" price cap regulation currently existed, price caps are not, by themselves, sufficient to eliminate incentives to misallocate costs. The Commission's cost allocation rules are therefore another important tool, along with other safeguards, to complement price cap regulation.

2. In all events, as AT&T's prior *ex parte* has shown, the Commission could not lawfully exempt broadband services, if they were deregulated, from its cost allocation rules without adopting other "necessary cost allocation rules," accounting safeguards, and guidelines,

<sup>&</sup>lt;sup>6</sup> To be sure, Congress has prohibited the prices for network elements to be based on historical costs, *see* 47 U.S.C. § 252(d)(1), and the Commission has adopted TELRIC pricing rules that examine the costs incurred by an efficient carrier, but that has not prevented the incumbent LECs from advancing cost models and UNE prices that are purportedly consistent with the Act and those rules but that in fact are rife with backward-looking data based on the incumbents' actual costs – costs that would be even more inflated if BellSouth's request for an exemption from the cost allocation rules were granted.

as required by Section 254(k), that would ensure that all "services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities to provide those services." 47 U.S.C. § 254(k). BellSouth's primary response repeats its basic claim, contending that the cost allocation rules cannot be "necessary" within the meaning of Section 254(k) because of the existence of price caps. See Letter at 7. But as described above, the Commission has always considered its cost allocation rules to be "important" safeguards against cost misallocation even with the existence of price caps. Accounting Safeguards Order ¶ 271. Further, in its order implementing Section 254(k), the Commission specifically relied on its existing cost allocation rules as the safeguards that Section 254(k) requires. See Section 254(k) Order ¶¶ 3, 6, 8. The Commission could not simply eliminate those rules with respect to broadband services without offering some explanation of why any remaining safeguards are "sufficient" to prevent incumbents from misallocating joint and common costs away from broadband services and onto the rates for local services included in the definition of universal services, in violation of Section 254(k). See Brae Corp. v. U.S., 740 F.2d 1023, 1038 (D.C. Cir. 1984) (when an agency "abandon[s] existing rules and policies, . . . the agency must explain why the original reasons for adopting the rule or policy are no longer dispositive").

BellSouth's further and related contention (Letter at 7) that there is "nothing to demonstrate that an allocation of costs is necessary in this situation to prohibit competitive services being subsidized by noncompetitive services" ignores basic economics: carriers with market power have powerful incentives to "recover the costs of competitive services from subscribers to less competitive, regulated services by misallocating the costs of their competitive services." Section 254(k) Order ¶ 2. Thus, even a "cursory glance of the regulatory history of telephone companies" would be enough for the Commission to conclude that its cost allocation rules are necessary here to prevent cost misallocation by the incumbents. Southwestern Bell, 896 F.2d at 1381. And the Commission could not exempt broadband services from cost allocation rules without explaining why these fundamental principles are somehow inapplicable in this context.

<sup>&</sup>lt;sup>7</sup> And because price caps were applicable to incumbents in 1996, Congress's enactment of Section 254(k) implicitly recognized that price caps alone are not sufficient to guard against the risks of cross-subsidization. Thus, the Commission could not simply adopt BellSouth's analysis that price caps could provide the necessary safeguards against misallocation of joint and common costs.

<sup>&</sup>lt;sup>8</sup> The fact that these rules are "necessary" to detect cost misallocation, however, does not mean that they are also sufficient in all cases to prevent incumbent LEC abuses. Thus, the Commission has properly instituted additional regulatory safeguards, such as an outright ban on sharing of operating, installation and maintenance functions between a BOC and its long distance affiliates, where there are such "substantial opportunities" for cost misallocation that its cost allocation rules could not prevent by themselves. *See Implementation of the Non-Accounting Safeguards of Sections 271 and 272*, 11 FCC Rcd. 21905, ¶ 163 (1996).

No such explanation is possible, because there is no doubt that these general regulatory principles and the specific concerns addressed by Section 254(k) are directly implicated here. Section 254(k) requires that rates for the incumbents' traditional local services (which are included within the definition of universal service) "bear no more than a reasonable share" of the joint and common costs used to provide those services. Because (as BellSouth does not dispute) broadband services share many joint and common costs with traditional local services, application of existing cost allocation rules is plainly necessary to ensure that incumbents do not load all of the joint and common costs onto traditional local services, providing them with an unfair advantage in pricing their newly deregulated broadband services and burdening captive ratepayers. This is particularly true because broadband services "us[e] the traditional telephone platform," *Notice* ¶ 9, thus exacerbating the risks that carriers can disguise costs for such services as regulated service costs.

- BellSouth complains (Letter at 2) that it might be burdensome to separate broadband costs from traditional local services costs. If there were a significant burden, that would merely reflect the large level of joint and common costs between broadband and traditional local voice services, and thus the massive opportunity that incumbents would have to misallocate costs if the requested exemption were granted. Thus, any burden is plainly justified to avoid the acute risk of cost misallocation. If anything, the claim that "requiring ILECs to allocate joint and common costs to broadband services would be the exception that would swallow any other broadband relief the Commission might grant" (Letter at 2) simply highlights why broadband services should not be de-regulated in the first instance: the incumbents retain dominance over critical bottleneck facilities, including facilities used to provide broadband, and they have the incentive and in the absence of regulations like the cost allocation rules the ability to abuse that bottleneck in every market they enter, including broadband.
- 4. Finally, with respect to universal service issues, BellSouth's response provides no valid evidence of a competitive disadvantage that incumbents face versus cable providers due to universal service contributions that incumbents make. As AT&T showed in its previous ex parte, cable providers generally do not provide to independent ISPs the wholesale transport services that incumbents offer and that trigger universal service contributions. BellSouth agrees that cable providers are not required to provide such services, Letter at 9, but states that "[i]n every situation where cable modem providers are offering wholesale services to ISPs they are competing with ILEC's DSL service for that business." *Id.* Of course, that statement is not at all responsive to the issue, which is whether there are in fact significant "situations" where cable modem providers are offering wholesale services to ISPs and whether there is any material disadvantage to incumbents because of universal service requirements. BellSouth offers no evidence whatsoever to show that cable providers are in fact offering such services, so nothing in the record could allow the Commission to credit BellSouth's claims that there is some competitive disadvantage because of USF contributions.

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Sincerely,

Michael J. Hunseder